DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0093
Gross Income Tax
For the 1998 Tax Year

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ISSUES

I. Gross Income Tax – Construction Management Company Acting in an Agency Capacity.

Authority: IC 6-2.1-2-2(a)(1); IC 6-2.1-2-2(a)(2); Western Adjustment and Inspection Co. v. Gross Income Tax Division, 142 N.E.2d 630 (Ind. 1957); Policy Management Systems Corp. v Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999); Monarch Steel Co. v. State Bd. Of Tax Comm'r, 699 N.E.2d 809 (Ind. Tax Ct. 1998); Trinity Episcopal Church v. State Bd. Of Tax Comm'r, 694 N.E.2d 816 (Ind. Tax. Ct. 1998); Universal Group Limited v. Indiana Department of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994); 45 IAC 1-1-54; 45 IAC 1-1-54(1); 45 IAC 1-1-54(2); 45 IAC 1-1-100; 45 IAC 1-1-105.

Taxpayer argues that because it was acting merely in an agency capacity when it accepted from the owner of a construction project payments due subcontractors, it should not be liable for gross tax income tax on those payments. Taxpayer maintains that the existence of an agency relationship between itself and the building owner can be established by the law and the facts.

II. Apportionment of Taxpayer's Income Between Labor and Materials.

Authority: IC 6-8.1-5-1(a); IC 6-8.1-5-1(b); 45 IAC 1-1-100.

In the event the Department determines that there was no agency relationship between taxpayer and the building owner, taxpayer argues that, for the construction project here at issue, the audit incorrectly apportioned the amount of income between money received for material and money received for labor.

STATEMENT OF FACTS

Taxpayer is an out-of-state domiciliary engaged in the construction management business. Taxpayer oversees the construction of large commercial and industrial buildings. Taxpayer contracts with a building owner on either a lump sum or cost plus fee basis for the construction of the building. The construction project here at issue was based on a cost plus fee arrangement. In a cost plus fee arrangement, the taxpayer is compensated at actual cost for all materials,

equipment, rentals, and subcontracts. In addition, the taxpayer is reimbursed for the hourly salary of the taxpayer's own employees together with a multiplier. The taxpayer is reimbursed for the salary of administrative personnel together with both a multiplier and a flat fee. The salary, overhead multipliers, and flat fee are set forth in the taxpayer's contract with the building owner. The taxpayer then enters into contracts with the individual subcontractors working at the particular building project. The contracts between taxpayer and the subcontractors are lump sum contracts. Taxpayer oversees the subcontractor bidding process, construction procedures, billing, administration, scheduling, inspection, and coordination of the entire building project. Taxpayer's own on-site employees include scheduling managers, construction managers, superintendents, and engineers. During the audit period, the taxpayer supervised two construction projects in Indiana.

For one of the Indiana construction projects, taxpayer failed to report either labor or material receipts for gross income tax purposes. Taxpayer maintained that the gross income received for that particular construction project was derived from the receipts taxpayer received in an agency capacity. According to taxpayer, it acted merely as a "pass-through" agent between the individual subcontractors and the building owner.

The audit determined that there was no agency relationship between the individual subcontractors and the building owner. Accordingly, the audit determined that the money taxpayer received from the building owner was subject to gross income tax.

DISCUSSION

I. Gross Income Tax – Construction Management Company Acting in an Agency Capacity.

Indiana imposes a gross income tax upon the entire gross receipts of a taxpayer who is a resident or domiciliary of Indiana. IC 6-2.1-2-2(a)(1). For the taxpayer who is not a resident or domiciliary of Indiana, the tax is imposed on the gross receipts which are derived from business activities conducted within the state. IC 6-2.1-2-2(a)(2). It is undisputed that taxpayer is not a resident or domiciliary of Indiana but that it received gross receipts from construction activities conducted within the state. However, 45 IAC 1-1-54 exempts that portion of a taxpayer's income which the taxpayer receives while acting in an agency capacity. That regulation states:

Taxpayers are not subject to gross income tax on income they receive in an agency capacity. However, before a taxpayer may deduct such income in computing his taxable gross receipts, he must meet two (2) requirements:

> (1) The taxpayer must be a true agent. Agency is a relationship which results from the manifestation of consent by one person to another authorizing the other to act on his behalf and subject to his complete control, and consent by the other to so act. Agency may be established by oral or written contract, or may be implied from the conduct of the parties. However, the representation of one party that he is an agent of another without a manifestation of consent by the alleged principal is insufficient to establish an agency. Both parties must intend to act in such a relationship.

> Characteristic of agency is the principal's right to complete and continuous control over the acts of the agent throughout the entire performance of the contract. This right to control cannot be limited to the accomplishment of a desired result. In addition, the principal must be liable for the authorized acts of the agent.
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> (2) The agent must have no right, title, or interest in the money or property received or transferred as an agent. In other words, the income received for work done or services performed on behalf of a principal must pass intact to the principal or a third party; the agent is merely a conduit though which the funds pass. A contractual relationship whereby one person incurs expense under an agreement to be reimbursed by another is not an agency relationship unless the other elements of agency exist, particularly the element of control discussed above. Where tangible personal property is purchased by an agent for a principal, title need not vest immediately in the principal in order for the agent's reimbursement to be deductible if there is an agreement between the parties authorizing one to purchase on behalf of other. However, income derived from sales by the principal and subsequent resale by the agent to customer is subject to gross income tax.

In summary, when applying the above facts to a taxpayer, the critical factor is that of control. Notwithstanding the fact that the taxpayer acting for another has no right, title or interest in the money or property received, he is not entitled to deduct such income from his gross receipts unless he was acting as a true agent subject at all times to the control of his principal.

The Indiana Tax Court in Policy Management Systems Corp. v Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999) and Universal Group Limited v. Indiana Department of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994) reviewed the relationship between the imposition of the state's gross income tax and agency principles, echoed the regulatory standards set out in 45 IAC 1-1-54, and found that an agency relationship required consent by the principal, acceptance and authority by the agent, and control of the agent by the principal.

The taxpayer has the burden of establishing that the reimbursements received from the building owner were not subject to the state's gross income tax. *See* Western Adjustment and Inspection Co. v. Gross Income Tax Division, 142 N.E.2d 630, 635 (Ind. 1957). When discussing tax exemptions, such as 45 IAC 1.1-6-10, the courts have held that the exemptions are strictly construed against the taxpayer and in favor of taxation. Monarch Steel Co. v. State Bd. Of Tax Comm'r, 699 N.E.2d 809, 811 (Ind. Tax Ct. 1998). Trinity Episcopal Church v. State Bd. Of Tax Comm'r, 694 N.E.2d 816, 818 (Ind. Tax. Ct. 1998).

Taxpayer argues that it was the building owner's agent and that money it received from the building owner was merely "passed through" to the individual subcontractors. To that end, taxpayer maintains that it has presented sufficient evidence demonstrating that the taxpayer and the building owner both intended and established an agency relationship. An agreement between taxpayer and the building owner, dated April 2, 1998, specifically identified – for sales tax indemnification purposes – the taxpayer as agent for the principal. A letter directed to the Department by the building owner and dated July 10, 2000, indicates that the building owner intended to enter into an agency relationship with the taxpayer. The agreements between the taxpayer and the various subcontractors, reference the building owner as the proprietor of the Indiana construction project.

In addition to this documentary evidence, the taxpayer argues that the parties' conduct evinces an agency relationship between taxpayer and the building owner. When making the final selection of a subcontractor, the taxpayer would forward to the building owner a list of the qualified subcontractors together with a recommendation as to which of the qualified subcontractors should be chosen. The building owner was entitled to accept or reject the taxpayer's recommendation. In addition, the building owner issued separate purchase orders for the payment of taxpayer's management services and for the payment of subcontractors.

Further, taxpayer argues that the method by which the various subcontractors received monthly payments further evidences the existence of an agency relationship. Under the subcontractor agreements, the subcontractor was required to make a monthly payment request to the taxpayer. The subcontractor's monthly request delineated the materials and labor expended by the subcontractor. After the taxpayer approved the payment request, a payment request was submitted to the building owner. The building owner paid taxpayer the amount requested, taxpayer received and deposited the amount into its own unsegregated bank account, and taxpayer – in turn – paid the individual subcontractor after the subcontractor demonstrated that there were no liens on the property and that the materials expended had been paid for. The individual subcontractor agreements stipulated that taxpayer was to pay each subcontractor within five days after receiving payment from the building owner. In addition, the subcontractor agreements conditioned the subcontractor's payment upon taxpayer's own receipt of the money from the building owner.

There is no record of the original agreement, governing the $24,000,000 Indiana building project at issue, between the taxpayer and the building owner. The taxpayer and building owner apparently agreed that taxpayer would be compensated by reference to the terms of a previous construction project agreement. According to taxpayer, no record of that predecessor agreement is available.

In order to find that the taxpayer was acting as an agent for the building owner, the taxpayer must establish that it was authorized to bind the building owner as the principal. 45 IAC 1-1-54(1). The various agreements between the taxpayer and the subcontractors do not demonstrate such authority. To the contrary, the subcontracts are binding agreements between the subcontractor and the taxpayer. As the agreement itself states, "The Trade Contractor [subcontractor] agrees to be bound to and assume toward the Construction Manager [taxpayer] all of the obligations and responsibilities that the Construction Manager . . . assumes toward the Owner." The agreements bind the subcontractor to perform construction work to the satisfaction of the taxpayer. The subcontractor is required to adhere to a work schedule established by taxpayer. The subcontractor is liable to the taxpayer for any liquidated damages which the taxpayer incurs by reason of any failure on the part of the subcontractor. The subcontractor is precluded from performing any extra work unless approved in writing by the taxpayer. The subcontractor agrees to any changes in the scope of the construction project as dictated by the taxpayer. If the subcontractor finds itself unable to perform the required work, the taxpayer is "at liberty to terminate the employment of the Trade Contractor." In essence, the subcontracts are agreements exclusively between the individual subcontractors and the taxpayer with the taxpayer retaining total authority over the subcontractor. As the agreement specifically states, "the Construction Manager [taxpayer] reserves the right to terminate this Agreement for its convenience upon written notice to the Trade Contractor." In return for the obligations assumed by the subcontractor, the taxpayer specifically agrees "to pay the Trade Contractor for the

satisfactory performance of his work the total sum of: [contract price].” Although, the subcontractor agreements make reference to the building owner, there is no indication whatsoever that taxpayer was binding the building owner to any portion of the agreement between the taxpayer and the subcontractors.

That taxpayer conditioned the subcontractors’ monthly payments upon receipt of the building owner’s payment is, standing alone, an irrelevancy. The agreements between taxpayer and the subcontractors contained numerous conditions precedent each of which needed to be fulfilled before the subcontractor received payment.

Taxpayer entered into agreements with its subcontractors whereby both parties bound themselves to the terms of those agreements. The subcontractors agreed to perform construction work at the direction of and to the satisfaction of the taxpayer. Taxpayer agreed to pay – subject to certain conditions precedent – the subcontractors for that construction work. The building owner was a third-party bystander to those agreements. Absent any indication that the taxpayer was entitled to bind the building owner to the agreements’ terms, under 45 IAC 1-1-54(1) the taxpayer’s argument, that it was acting as an agent of the building owner, must fail.

By the terms of the agreements between taxpayer and the subcontractors, taxpayer took upon itself the obligation to pay the subcontractors. The terms of the agreement between taxpayer and the building owner – the exact nature of which remains undetermined – apparently obligated the building owner to pay the taxpayer the costs incurred in making payment to the subcontractors. Lacking any other reasonable means of describing that arrangement, such a payment appears to be in the nature of a reimbursement. As specifically set out in 45 IAC 1-1-54(2), “A contractual relationship whereby one person incurs expense under an agreement to be reimbursed by another is not an agency relationship unless the other elements of agency exist . . . .”

Taxpayer produced documentary evidence, originating with the building owner, which unmistakably indicates that the parties *intended* to enter into an agency relationship. However well intentioned the parties may have been, the documentary evidence is insufficient to establish the existence of an agency relationship in the face of the parties’ actual conduct. Rather, the parties’ conduct demonstrates that the building owner engaged taxpayer for the purpose of exploiting the taxpayer’s ability and experience in expediting the completion of a major building project. In turn, taxpayer hired the subcontractors necessary to complete the project. In turn, the building owner repaid the taxpayer for the obligations which the taxpayer assumed toward the subcontractors. The documentary evidence of the parties’ intentions aside, such an arrangement does not evidence an agency relationship.

Taxpayer argues that the payments received from the building owner were merely passed through to the individual subcontractors by the taxpayer acting in its agency capacity. However, the circumstances surrounding the payment transfers demonstrated that taxpayer exercised independent authority and control over the funds. Taxpayer deposited the amounts it received from the building owner into its own unsegregated general bank account. These amounts, received for the purpose of reimbursing the individual subcontractors, were intermingled with taxpayer’s own funds. Those same amounts earned interest to the taxpayer’s benefit during the brief time the funds remained deposited in the taxpayer’s bank account. In addition, the taxpayer was entitled to indefinitely delay the subcontractor’s final payment until the taxpayer had secured a general release from the subcontractor. Although the subcontractor agreements stated that the subcontractors would receive payment within five days after taxpayer received payment

from the building owner, clearly taxpayer was entitled to treat the money as its own during that five days or during the indeterminate time in which the subcontractor was unable to produce a general release. As 45 IAC 1-1-54(2) states, in order to qualify as an agent, "[t]he agent must have *no right, title or interest in the money or property received* or transferred as an agent. In other words, the income received for work done or services performed on behalf of a principal must pass intact to the principal or a third party; the agent is merely a conduit through which the funds pass." (*Emphasis added*).

Finally, whatever agency arguments the taxpayer may set forth, regardless of the parties' intent, and regardless of the precise circumstances surrounding the transactions here at issue, taxpayer's argument is precluded by the plain language of 45 IAC 1-1-105. The regulation states that "[c]ontractors are taxed at the applicable rate upon the entire amount derived from the performance of their contracts *without deduction for amounts paid to sub-contractors, costs of labor, costs of material or any other costs or expenses.*" (*Emphasis added*). Although taxpayer labels itself as a "construction management company," taxpayer nonetheless falls with the regulatory definition of "contractor." As set out in 45 IAC 1-1-100, "The term 'contractor' means any taxpayer obligated under the terms of a contract, except a contract of sale, to furnish the necessary required labor, material and other elements of cost for the performance of construction, erection, installation or any other service work for another person regardless of the form of the contract or whether it is performed on a lump-sum, cost-plus-a-fixed-fee, percentage-of-cost, or any other basis or whether such taxpayer the general, prime, or subcontractor."

FINDING

Taxpayer's protest is respectfully denied.

II. Apportionment of Taxpayer's Income Between Labor and Materials.

During the audit, the portion of the contract revenue attributable to the construction project at issue was apportioned between revenue received for labor and revenue received for materials. That apportionment was based upon the available records submitted by the subcontractors for the two Indiana construction projects. The audit determined that 72 percent of the taxpayer's income was attributable to labor and 28 percent was attributable to materials. At the time of the audit, both the auditor and the taxpayer agreed that this apportionment was based upon the best information available and accurately reflected the taxpayer's operating results.

In the absence of primary information authoritatively differentiating between the revenue received for labor from the revenue received for materials, IC 6-8.1-5-1(a) requires that the audit arrive at a tax assessment based on the "best information available." The law states that, "If the department reasonably believes that a person has not reported the proper amount of tax due, the department *shall* make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department." (*Emphasis added*).

Taxpayer now argues that the audit's determination incorrectly apportioned labor and materials for the single construction project here at issue. Taxpayer maintains that it can produce information establishing that – for the construction project here at issue – the correct apportionment should be 29 percent for labor and 71 percent for materials. The significance of the distinction is found at 45 IAC 1-1-100 which states that, "Under a cost-plus contract, the

actual material cost will be taxed at the lower rate, and labor, overhead and fixed fee will be taxed at the higher rate." Adoption of the taxpayer's apportionment scheme would decrease taxpayer's gross income tax liability.

The audit's determination of taxpayer's liabilities arrives with a presumption of correctness. IC 6-8.1-5-1(b) states that "[t]he notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Taxpayer's assertion concerning the proper apportionment between and labor and materials revenue is based on its interpretation of the "best information available." Taxpayer does not – nor is it entitled to do so – maintain that its apportionment is based on a definitive analysis of the actual revenues derived from the project under examination. Essentially, taxpayer argues that its analysis is more favorable on its own behalf and should be accepted by the Department in lieu of the audit's determination. The argument fails because taxpayer does not meet its burden of overcoming the presumption of correctness, under IC 6-8.1-5-1(b), accorded the audit's original determination.

FINDING

Taxpayer's protest is respectfully denied.

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